



weathering regulatory storm

It was not long ago that the words *mutual fund* conjured up images of a conservative, middle of the road way for investors to participate in the most sustained bull market in history. However, say the words today and many industry participants think of something quite different... regulation.

Few would argue that financial institutions are currently under a tremendous amount of regulatory pressure. Heightened awareness around terrorism, scandals involving late day trading, market timing and other improprieties are just a few of the reasons why the financial services industry finds itself at the center of a regulatory hurricane. With the large onslaught of federal regulations, industry participants find themselves faced with navigating a plethora of new and complicated rules and requirements, many of which have changed the way business is conducted.

"Whether it's Sarbanes Oxley, the Patriot Act, the European Savings Directive, or the Chief Compliance Officer Rule, new regulations are emerging from every direction, in countries around the world," says Neil Henderson, Securities Processing and Fund Services business executive, JPMorgan Investor Services. "The increasing burden of compliance responsibilities and the level of adherence required will continue to escalate, increasing pressure on clients not only to improve their compliance processes to meet today's requirements, but also continue to enhance and adopt best practices."

"This is a journey. It's not like the October 5th deadline — that required mutual funds and their advisors to appoint Chief Compliance Officers (CCO) and implement comprehensive programs to prevent violations of SEC regulations and securities laws — passed and we could all return to the way it

used to be. These new mandates require heightened scrutiny, and JPMorgan very much wants to be part of the journey with you,” notes Virginia Meany, Fund Services Western Hemisphere business executive, JPMorgan Investor Services, at a series of client forums JPMorgan Investor Services hosted in New York and Boston on the CCO rule. The forums were designed to help clients navigate the maze of new regulatory requirements and to provide them with information on how JPMorgan Investor Services Compliance Solutions Program could help transform operational risk management from a regulatory requirement into competitive advantage.

“We believe that as an organization, and as a top service provider in the industry, that we need to be and very much want to be, in a leadership role as we define the response and define the best practices in the industry regarding these and other regulations to come,” Meany said.

Mutual Funds Appoint CCOs

Critical new regulations include the Investment Company Act of 1940 Rule 38a-1, and the Investment Advisors Act of 1940 Rule 206(4)-7, which went into effect this past October 5th. The rule requires mutual funds and investment advisers to appoint a CCO and implement comprehensive policies and procedures to prevent funds and advisers from violating federal securities laws. Under the rule, fund boards must annually approve the policies and procedures of service providers, oversee those providers, and policies and procedures annually. Where the SEC’s Office of Compliance Inspections and Examinations (OCIE) counsels participants to, “Use the opportunity that the new rule presents to question past practices...”¹ considerations such as costs and the practicality of implementation are serious concerns for clients.

An October 2004 study by Cerulli Associates, a Boston-based research and consulting firm, states that, “Rising compliance costs continue to impact asset managers’ profitability. As firms spend more time, resources, and money to stay up-to-date on current and proposed regulation, staff, budgets, and outsourcing are expected to increase.”²

Further, www.ignites.com recently reported on that same Cerulli study, which asked 40 asset management firms, including more than 20 mutual fund managers, to grade the importance of seven different factors that impact profits. When asked to rank costs that harm profitability on a scale of zero to seven, with seven representing the most significant items, compliance issues scored a 4.38 on an industry wide basis.³

“It’s true that we’ve seen an enormous number of new rules over the last two years. For example, the SEC has significantly stepped up its scrutiny of daily mutual fund valuation placing a greater burden on fund administrators to come up with ways to fairly value shares and ultimately, discouraging trading abuses to safeguard long-term shareholder rights. SEC regulations are nothing new,” says Meany. “Regulators have had to respond to political pressure as people began to ask how situations like Enron and a WorldCom could happen. As a result, they are getting increasingly aggressive in their rulemaking and oversight.”

Not just a U.S. development, the level of focus on regulatory issues is intensifying in Europe and Asia as well (see also “Regulation: Will Europe’s Financial Action Plan Succeed?” page 11, and “China’s Regulations Offer First Time Opportunities,” page 14). “Regulators realize that if it can happen in America, it could happen in their country too,” says Meany. “There are a host of new regulations globally that require the financial industry and public companies to perform assessments on their key processes.” The considerable amount of additional work required of companies to become compliant with the new regulations is unarguable, but Meany suggests that looking at the regulations as an opportunity to implement more efficient business practices can be a benefit.

Value-Added Support

“This regulatory environment is unlike any we’ve seen in recent history, but it is a reality we have to face,” Meany says. “Our goal is to work beyond just providing policies and procedures. We also want to help clients establish

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best practices and facilitate due diligence, offering clients tools that can assist and support them to be as responsive to the regulations as possible.”

In addition to the CCO Client Forums, the Investor Services team worked during 2004 to support its custody and full service fund accounting and administration clients with the CCO rule in a number of ways. By consulting with clients and industry experts, Investor Services developed a program that included providing detailed summaries of its compliance policies, procedures and controls. This cut down on the volumes of documents clients were required to review before the deadline. The firm also provided one-on-one support to clients and fund boards to help them prepare for representing to their own fund board that their compliance program is adequately designed.

Rule 38a-1 designated that CCOs were to have been appointed by October 5th, 2004. Already, the OCIE has commenced telephone inspections of mutual funds and investment advisers, where each of its regional offices has or will contact area fund groups to question their compliance with the CCO rule. “It is more important than ever for CCOs to source solutions that help them satisfy regulatory requirements with exceptional reliability and work to relieve the ever increasing compliance related administrative burdens,” Meany explains.

The industry is currently in the implementation and monitoring period, as is required by the rule. This involves activating the CCO office and putting its mechanics into practice. Investor Services plans to continue to support clients with a range of core and premium services. Beginning in the second quarter of 2005, Investor Services will communicate an assessment of its control environment through internally generated client representation letters, and third party SAS 70 reports. Further, updates to already provided policies and summaries will also be disseminated annually. Investor Services is still investigating the possibility of obtaining a third party

report relating to operations not currently covered in the SAS 70, depending on the recommendations made by the American Institute of Certified Public Accountants (AICPA) regarding the report’s design. More frequent reporting, client due diligence visits, and other JPMorgan services are also available to clients. All of these measures are oriented around supporting CCOs in connection with their annual evaluation of compliance with policies and procedures that will likely result in faster evolution of those policies and procedures to industry best practices.

Michael Leary, vice president, senior manager Fund Administration, says, “Policies and Procedures were only the beginning. Clients have a challenging task in front of them: to be ready for the post October 5th CCO deadline.”

“Although work leading up to the October deadline was important, what may be the most challenging and significant components remain,” Leary explains. “Clients will need to continually refine the materials already completed and design programs to show compliance and effectiveness. This task is complicated by expected enhanced oversight by regulatory agencies in the near future,” says Leary, who was recently appointed JPMorgan Investor Services Compliance Solutions Program manager. Leary has 16 years of investment company and advisor experience. He is a certified public accountant and is active in many industry specific communities and organizations.

“One of the biggest challenges for clients now is to determine how to project a culture of compliance and demonstrate the letter and spirit of how they will digest the new regulations as an organization,” says Greg Pickard, associate general counsel JPMorgan Investor Services. “Although much work has been completed to meet the first phase of the CCO rule, we may still have the greatest challenges ahead in designing the monitoring and implementation oversight phase.

“As an organization, and a top service provider, we believe it is important to take a leadership role in developing best practices with regard to industry regulations,” Henderson says. “The bar for compliance standards continues to rise, and we will increasingly present clients with not only an overview of the current regulatory environment, but also a number of compliance-focused solutions designed to help them deal with the ongoing wave of new rules.” ○○○

For more information, contact Michael Leary at (617) 557-8753.

1. “Compliance in a Time of Change” by Jane Worthington, *Securities Industry News*, October 1, 2004.
2. “Asset Management: Conquering Compliance Challenges,” summary page, www.cerulli.com.
3. “Compliance is Biggest Drain on Firms’ Profits” by Tom Leswing, www.ignites.com, November 17, 2004.

compliance tools

JPMorgan Investor Services Compliance Solutions Program includes a range of industry-leading tools that can assist advisors and funds in their efforts to ensure that their policies and procedures are reasonably designed to prevent violation of the federal securities laws.

Compliance Reporting Services

JPMorgan Investor Services Compliance Reporting Services provide institutional investors with automatic exception-based information, highlighting potential violations of pre-agreed investment guidelines, external regulations and internal risk exposure limits.

“A number of the enhancements we’ve recently made to our compliance reporting services can add value for clients facing the SEC’s CCO requirements,” says Bill Miller, product manager Compliance Reporting Services, JPMorgan Investor Services. Among those enhancements is an internet-based workflow management

tool available through JPMorgan AccessSM that Miller says, clients can use to document the resolution process of a compliance event. “We’ve received positive feedback from our clients that this is assisting them not only with their daily monitoring process of portfolios, but also in audit process documentation.”

JPMorgan Investor Services Compliance Reporting Service team works with clients to define and tailor rules and reports to their individual needs. Tests can be applied at the portfolio or multiple composite levels based on factors including: issuer, country, credit quality,

JPMorgan’s i-VAULT!

“There was a time when reports that boards of directors received in conjunction with fund activity may have ended up in the trash,” says Christopher Redvers, business development JPMorgan i-VAULT! “But today’s regulatory environment requires that those reports must be included in the fund’s official records. Indeed, just about every new SEC rule that is adopted today has a record-keeping requirement that comes along with it,” he says.

For example, the CCO rule requires policies and procedures to be retained for a minimum of five years, in as pure and unadulterated a form as possible. Redvers

says certain rules allow for exclusive electronic storage which is a great benefit to clients. “Many of the new regulations are putting additional record keeping pressures on investment advisers,” Redvers explains. “Imaging offers many advantages,” he says. “The technology is much more affordable than it used to be. Physical storage is an important issue for clients, particularly those in high cost metropolitan areas. Freeing up real estate can ultimately lead to significant cost savings.” In addition to faster access to documents, with JPMorgan’s i-VAULT! solution there is no more waiting for boxes to be delivered from a far away stor-

Plexus Group

“The CCO requirement is just the latest in an ever expanding mandate from the SEC focused generally on brokerage practices and requiring investment managers to obtain best execution,” says Marie Konstance, director of Sales and Product Management for JPMorgan’s Plexus Group. Plexus has been in the business of helping investment managers document and benchmark *Total Transaction Costs* and improve best execution for 18 years. With its long standing sound methodology, today’s compliance executives can utilize Plexus to provide Equity Transaction Cost Analysis in support of the best execution mandate.

“Clients look to Plexus for any number of reasons,” says Konstance. “They are often

concerned purely with reducing their costs while others want to understand if their traders or brokers are doing the best job possible. But in today’s heightened regulatory environment, the primary motivation to utilize our services is to comply with the SEC mandate for best execution,” she explains.

Plexus’ Alpha Capture[™] Service provides compliance executives with objective and independent analysis to satisfy expanded regulatory requirements. Plexus is not dependent on revenue from brokerage or investment management. “Clients say one of the most appealing aspects of the Plexus product is that it is independent,” Konstance says. “Plexus is not affiliated with any broker. As part of Investor Services we are completely distinct.”

maturity, and asset type. These tests can be run on a daily, weekly, or monthly schedule. Worldwide, the service has dedicated compliance reporting teams who support clients to set-up the service, build appropriate rules and support the application on a daily basis. Reporting is customizable, and is available for viewing through the internet or JPMorgan AccessSM.

The Compliance Reporting Service covers a wide range of investment compliance categories, including the Investment Company Act of 1940 and Investment Adviser Act of 1940 compliance regulation. Over 5000 client-defined rules are

available, covering equities, fixed income, derivatives, money market and cash equivalent restrictions.

Clients not currently receiving JPMorgan Investor Services custody or accounting services can also access the services through third party compliance. This service allows clients to transmit data via JPMorgan Access regarding their accounts and holdings, using their own file formats.

“Essentially we bring all aspects of a compliance reporting program into one spot, which is easy to use and highly customizable for our clients,” Miller says.

“To get a client up on the system, we take their rule requirements, regulatory restrictions, fund mandates and any other reporting requirements they have. We then document and interpret them with the client. JPMorgan Investor Services Administrators are then responsible for building the rules and maintaining the system, and then delivering the compliance events back out to the client. ○○○

For more information on JPMorgan Investor Services Compliance Reporting, contact Bill Miller at (718) 242-7863.

age facility which enhances clients’ record management program.

“The scope of JPMorgan’s own businesses and our diverse and extensive records retention requirements have created our own need for a comprehensive records retention system,” says Redvers. Originally developed as an internal JPMorgan image archive system, what sets i-VAULT! apart from other providers’ solutions is that there is no need to purchase or maintain hardware and software in-house. Clients don’t have to maintain a staff to manage storage media and or update their software in five years

when the technology has changed. i-VAULT! provides the core storage that allows clients to focus on their core business functions rather than building an in-house imaging archiving system.

i-VAULT! also provides clients with long term access to their documents and data; uploaded images are available on the internet for years. In addition, tapes or CDs are available as back up. “We see this as a natural extension of the physical safekeeping services JPMorgan provides,” Redvers explains. “i-VAULT! can also deliver the benefit of back up to clients’ physical storage.”

“With the routine sweeps the SEC has conducted or what they refer to as ‘themed examinations’, and the volume of information that must be retrieved and produced, the benefits of i-VAULT! technology are quite significant,” Redvers says. ○○○

For more information, contact Chris Redvers at (212) 552-3601 or call 1-866-2-iVAULT (1-866-248-2858), or e-mail i.vault@jpmchase.com.

JPMorgan Plexus evaluates total cost by calculating commission, market impact, timing and opportunity costs. Utilizing its own proprietary benchmark, the PAEG/L, Plexus estimates costs to establish a comparison. “The PAEG/L is a way to determine — on average, considering stock price movement, liquidity, capitalization, and various other factors — how much a trade should cost.” Konstance believes the PAEG/L is a more appropriate measure of trade costs than other industry benchmarks. “It takes the difficulty of the trade and other factors into account, where other benchmarks, such as volume weighted average price (VWAP, a widely used measure of trade costs) do not,” she says. “It looks at the conditions that traders really trade in.”

With documentation also critically important to growing compliance requirements, Plexus monitors best execution on a quarterly basis by documenting unusual and high costs, creating ready made, independent reports that can be presented at board meetings or utilized for audit purposes. In addition, it creates broker activity reports that provide cost benchmarking comparisons, exception reporting and extensive broker performance analysis providing a consolidated package that may be permanently stored for best execution reports. All of this data can be accessed on line as well.

Currently Plexus is helping over 200 financial institutions navigate the best execution environment. Konstance says, “Our clients have come to rely on our independent and

objective analysis and recommendations. This translates into solutions that are responsive to the SEC requirement by seeking to measure *Total Transaction Costs* and best execution, and that add value to our clients’ investment returns.” ○○○

For more information, contact Marie Konstance at (718) 242-3165 or visit our booth at the FRA Best Execution conference in New York, January 31–February 1, 2005.

Log on to www.plexusgroup.com to request a reprint of “Transaction Costs and Best Execution: Compliance and Measurement,” published in *Institutional Investor* by our chairman, Wayne Wagner.